UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
	:	
Plaintiff,	:	03 Civ. 671 (DLC)
-v-	:	
	:	OPINION & ORDER
KPMG LLP, et al.,	:	
	:	
Defendants.	:	

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DENISE COTE, District Judge:

The Securities and Exchange Commission ("SEC") has moved to dismiss three affirmative defenses pleaded in the answers filed

by defendants in this action.[1] For the following reasons, the motion is granted.

Background

On January 29, 2003, the SEC filed this action against KPMG LLP, an accounting firm, and four individuals who are or were KPMG partners, for violations of the securities laws in connection with audits KPMG conducted of the financial results of the Xerox Corporation for the years 1997 through 2000. The four defendants who have answered,[2] have pleaded affirmative defenses of laches, undue delay, estoppel, waiver, unclean hands, and statutes of limitations. The defendants have agreed to withdraw the defenses of laches and undue delay. The defenses of estoppel, waiver and unclean hands arise from the following allegations by KPMG, which are accepted as true for purposes of this motion.

In March 2001, during the course of an SEC investigation, the SEC presented KPMG with some Xerox documents that KPMG had not seen before. KPMG demanded explanations of the documents from Xerox, and at KPMG's insistence, Xerox convened a special meeting of its Audit Committee. Because of KPMG, the Audit Committee retained outside counsel to conduct an independent investigation (the "Special Investigation"). Then, on May 24, 2001, KPMG representatives met with high-ranking members of the SEC Enforcement Staff to answer questions regarding the Special

[1] The motion to dismiss the statute of limitations defense is addressed by an Order issued today.

[2] Defendant Joseph T. Boyle has moved to dismiss the Complaint.

Investigation and the Xerox audit. At that meeting, KPMG inquired as to whether there were other matters of which KPMG should be aware in connection with the SEC's investigation that might impact on Xerox's financial statements.

The SEC responded to this inquiry on May 25, 2001. In a conference call with high-ranking members of the SEC Enforcement Staff, the SEC indicated concern that Xerox had not made certain disclosures in the notes to its financial statements, pointing specifically to issues related to Xerox's accounting for sales-type leases, including margin normalization and residual value accounting. The SEC indicated its belief that those issues merited additional disclosure. The SEC did not advise KPMG at that time that it considered Xerox's accounting methodology for sales-type leases to be fraudulent or not in compliance with GAAP. In response to an inquiry as to whether there were other accounting issues that the SEC thought needed to be addressed, the SEC responded that KPMG had "hit them all."

KPMG issued its audit report on Xerox's 2000 financial statements "in the good faith belief that the SEC was satisfied with the conclusions that it had reached and that it had 'hit' all of the accounting issues." It argues that, had the SEC spoken about any concerns that the accounting methodology did not comply with GAAP, KPMG could have taken those views into account before issuing the audit.

On June 5, 2001, the SEC wrote to Xerox that it should consider the need to disclose that Xerox's accounting methodology for sales-type leases "departs from GAAP." On June 7, 2001,

Xerox filed its 2000 annual report and disclosed that the SEC had entered an order of a formal, non-public investigation of Xerox's accounting and financial reporting practices.

In August 2001, KPMG issued a lengthy management letter noting material weaknesses in Xerox's internal controls. Xerox thereafter terminated KPMG as its independent auditor. In April 2002, Xerox reached a settlement with the SEC that required Xerox to restate its financial statements.

Discussion

Rule 12(f), Fed. R. Civ. P., provides that "the court may order stricken from any pleading any insufficient defense . . . ." To succeed on a motion to strike, the plaintiff must show that:

> (1) there is no question of fact which might allow the defense to succeed; (2) there is no question of law which might allow the defense to succeed; and (3) the plaintiff would be prejudiced by inclusion of the defense.

SEC v. McCaskey, 56 F. Supp. 2d 323, 326 (S.D.N.Y. 1999). Although motions to strike are not favored, see William Z. Salcer v. Envicon Equities Corp., 744 F.2d 935, 939 (2d Cir. 1984), vacated on other grounds, 478 U.S. 1015 (1986), "where the defense is insufficient as a matter of law, the defense should be stricken to eliminate the delay and unnecessary expense from litigating the invalid claim." Simon v. Mfrs. Hanover Trust Co., 849 F. Supp. 880, 882 (S.D.N.Y. 1994) (citation omitted); see also McCaskey, 56 F. Supp. 2d at 326.

The three equitable defenses at issue on this motion are estoppel, waiver and unclean hands. The federal doctrine of

equitable estoppel applies when "the enforcement of the rights of one party would work an injustice upon the other party due to the latter's justifiable reliance upon the former's words or conduct." Kosakow v. New Rochelle Radiology Associates, P.C., 274 F.3d 706, 725 (2d Cir. 2001). The elements of the defense include proof that the plaintiff made a misrepresentation of fact to the defendant with reason to believe that the defendant would rely upon it; that the defendant did reasonably rely upon it; and that the defendant was harmed by the reliance. Id. Ordinarily, whether the defense applies is a question of fact. Id. It is unnecessary for the defendant to show that the plaintiff intended to deceive the defendant when it made the representation. Id. at 726; see also Heckler v. Commun. Health Servs., 467 U.S. 51, 59 (1984).

Because the "Government may not be estopped on the same terms as any other litigant," given the importance this nation places on "obedience to the rule of law" and the Government's duty to enforce the law, id. at 60, an assertion of estoppel against the Government requires at the very least a showing that the Government's misrepresentation was inconsistent with the "minimum standard of decency, honor, and reliability" which citizens have a right to expect from their Government. Id. at 61. "The doctrine of equitable estoppel is not available against the government except in the most serious of circumstances, and is applied with the utmost caution and restraint." Rojas-Reyes v. Immigration & Naturalization Serv., 235 F.3d 115, 126 (2d Cir. 2000) (citation omitted); see also United States v. RePass, 688

F.2d 154, 158 (2d Cir. 1982). The Second Circuit has declined to apply the doctrine of estoppel against the SEC where the SEC did not issue a written opinion and its communications were only a part of a series of investigations "which ultimately provided the SEC with sufficient understanding of the underlying scheme" to file the complaint then before the court. See Graham v. SEC, 222 F.3d 994, 1008 (2d Cir. 2000). The Second Circuit explained that "the SEC's failure to prosecute at an earlier stage does not estop the agency from proceeding once it finally accumulated sufficient evidence to do so." Id. & at n.26 (collecting cases).

Waiver is the "intentional relinquishment of a known right." Hamilton v. Atlas Turner, Inc., 197 F.3d 58, 61 (2d Cir. 1999) (distinguishing waiver from forfeiture). See Johnson v. Zerbst, 304, U.S. 458, 464 (1938).

Generally, "the doctrine of unclean hands may not be invoked against a government agency which is attempting to enforce a congressional mandate in the public interest." SEC v. Rosenfeld, No. 97 Civ. 1467 (RPP), 1997 WL 400131, at *2 (S.D.N.Y. Jul. 16, 1997) (citation omitted). The doctrine of unclean hands, like other equitable defenses, may be raised against the Government where "the agency's misconduct [was] egregious and the resulting prejudice to the defendant r[o]se to a constitutional level." Id. (citation omitted); see also SEC v. Lorin, No. 90 Civ. 7461 (PNL), 1991 WL 576895, at *1 (S.D.N.Y. June 18, 1991).

The three equitable defenses rest on a conversation in May 2001, and therefore, to the extent reliance is properly part of any analysis, are available solely as to those claims addressed

to the 2000 audit, the only KPMG audit of Xerox that was completed, executed and filed after that conversation. These defenses are properly dismissed.

Accepting the descriptions of the conversation and the chronology of the events as presented by the defendants, they cannot as a matter of law establish that the defendants could have reasonably relied upon the May 2001 statements of the SEC either to relieve them of their obligation to perform an audit that conformed with the law, or to indicate that the SEC would not bring a civil suit based on the 2000 audit (an audit that the SEC had not yet seen). The defendants concede as much when they assert that it is not their position that the "SEC or its employees has responsibility for KPMG's audit. KPMG takes responsibility for its work."

Similarly, the conversation is insufficient as a matter of law to reflect an intentional relinquishment by the SEC of its right and duty under the law to file charges when it finds that charges are appropriate under the laws passed by the Congress. See Graham, 222 F.3d at 1008. The doctrine of unclean hands is likewise inapplicable since the SEC was acting to further its congressional mandate to investigate potential violations of the securities laws, and defendants do not -- and could not -- contend that the SEC's failure specifically to identify a violation of GAAP constituted egregious misconduct or prejudice that rose to a "constitutional level." Finally, the conduct described by the defendants cannot, as a matter of law, amount to a breach of the Government's duty to act with "decency, honor,

and reliability" vis a vis its citizenry. See Heckler, 467 U.S. at 61. The SEC has also shown that it will be prejudiced by allowing these affirmative defenses to remain in this litigation. The defendants have already given notice that they will seek to discover the internal workings of the SEC investigations of Xerox and KPMG to support these defenses.

This motion to strike is particularly appropriate since the statement on which the defendants rely was an oral statement. There is a mechanism available to obtain pre-clearance from the SEC for accounting actions and it requires both a written application and a written description of the staff's conclusion. The mechanism, contained in a publication entitled "Guidance for Consulting the Office of the Chief Accountant", reads in pertinent part, "companies should provide a written submission outlining the factual details, accounting considerations, financial statement impact, as well as the disclosures expected to accompany the accounting." The written submission is to be sent to the SEC at least five business days in advance of a meeting with the SEC staff about the issue. When the issue is resolved,

> a company may prepare and send to the staff a letter describing the company's understanding of the staff's position. In those instances, a draft of the letter should be sent for staff comment. The final letter may be incorporated into the Commission's files to document the position taken by the staff with respect to the specific company matter.

The opportunity to confirm guidance in writing is consistent with the general principle that estoppel cannot be asserted against

the Government "on the basis of ... oral advice...." Heckler, 467 U.S. at 65.

Finally, auditors like KPMG are required to comply with their professional obligations as accountants and their legal obligations under the securities laws: those duties do not cease once the SEC begins an investigation. In order to fulfill its own obligation to enforce the securities laws, the SEC must be able to conduct reasonable investigations without the risk that oral communications such as those alleged here will create a bar to the agency's pursuit of claims. Indeed, colloquy between the SEC and accounting firms is in the interest of the public, the Government, businesses, and their accountants. Allowing the assertion of these equitable defenses on the facts presented here would chill those conversations and be against the public interest.

Conclusion

For the reasons stated above, the SEC's motion to strike the affirmative defenses of estoppel, waiver, and unclean hands is granted.

SO ORDERED:

Dated: New York, New York
August 20, 2003

DENISE COTE
United States District Judge